87-713

No. ____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

SLAVKO ANDRIJEVIC, a/k/a AL ANDRIE,

Petitioner,

—v.—

C. RUSSELL KELLERAN, JR.,
EIGHTEEN MILE CORPORATION,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

EDWIN R. ILARDO
20 Buffalo Street
Hamburg, New York 14075
(716) 649-2880

Of Counsel

WILLIAM H. GARDNER
Hodgson, Russ, Andrews,
Woods & Goodyear
Suite 1800
One M&T Plaza
Buffalo, New York 14203
(716) 856-4000

Attorney for Petitioner
Slavko Andrijevic

QUESTIONS PRESENTED

1. Whether federal bankruptcy courts, notwithstanding their statutory duty to assure the fair distribution of the debtor's estate, lack any equitable power to review the merits of a creditor's claim based on a state court default judgment, particularly where other creditors who were not parties to the state court proceeding will be affected adversely?

2. Whether a state court judgment divests the bankruptcy court of any discretion to consider the merits of a creditor's claim in determining whether to "allow" the claim under 11 U.S.C. § 502?

3. Whether 11 U.S.C. § 105 gives a bankruptcy court discretion in an appropriate case to review the merits of a claim that has been reduced to a judgment?

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Slavko Andrijevic ("Andrijevic") respectfully prays for a writ of certiorari to review the judgment of a divided panel of the United States Court of Appeals for the Second Circuit, entered August 4, 1987.

OPINIONS BELOW

The majority opinion of the United States Court of Appeals for the Second Circuit, which reversed and remanded an order of the United States District Court for the Western District of New York, is reported at 825 F.2d at 692. The dissenting opinion is reported at 825 F.2d at 696. The October 17, 1986 opinion of the United States District Court for the Western District of New York, which affirmed an order of the Bankruptcy Court disallowing respondents' claims, is unreported. The opinion of the Bankruptcy Court dated May 24, 1985 also is unreported.

JURISDICTION

The judgment of the Court of Appeals was entered on August 4, 1987 and this Petition is being filed within 90 days thereafter. 28 U.S.C. § 2101(c). This

Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISION AND STATUTES INVOLVED

U.S. Const., art. I, § 8, cl. 4, provides in pertinent part:

> The Congress shall have Power . . . To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.

11 U.S.C. § 105(a) provides:

> **§ 105. Power of court.**
>
> (a) The court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking an action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 502 provides in relevant part:

§ 502. Allowance of claims or interests.

(a) A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.

(b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition. . . .

28 U.S.C. § 1738 provides:

§ 1738. State and Territorial statutes and judicial proceedings; full faith and credit.

The Acts of the legislature of any State, Territory, or Possession of the United States, or copies thereof, shall be authenticated by affixing the seal of such State, Territory or Possession thereto.

The records and judicial proceedings of any court of any such State, Territory or Possession, or copies thereof, shall be proved or admitted in other courts within the United States and its Territories and Possessions by the attestation of the clerk and seal of the court annexed if a seal exists, together with a

certificate of a judge of the court that the said attestation is in proper form.

Such Acts, records and judicial proceedings or copies thereof, so authenticated, shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State, Territory or Possession from which they are taken.

STATEMENT OF THE CASE

This case involves a conflict between a federal court's obligation to foster the policies underlying federal bankruptcy law, and its obligation to respect a state court judgment under 28 U.S.C § 1738. The panel majority of the Second Circuit ruled that a bankruptcy court has no power to review the underlying merits of a claim once that claim has been reduced to judgment by a state court. The dissenting opinion disagreed, arguing that Congress invested bankruptcy courts with broad equitable powers to treat all creditors fairly, including the power in an appropriate case

to examine the merits of a state court judgment.

Because this holding effectively prevents the bankruptcy courts from performing the prime function entrusted to them by Congress -- preventing injustice and unfairness to creditors in the distribution of the debtor's assets -- and because this case raises unresolved and recurring issues of importance in the administration of the bankruptcy laws on which the lower courts have reached contradictory results, this Court should grant certiorari.

A. Statement of Facts

In 1976 Andrijevic, who had been in the construction business, and Kelleran, a practicing attorney, formed Eighteen Mile Corporation (the "Corporation") for the purpose of purchasing certain plots of land, subdividing them, and reselling the

sublots for profit.[1] They initially invested and loaned equal sums of money to the Corporation. The Corporation then purchased property from a partnership in which Andrijevic was a partner.

In addition to dealing with each other as the two principals of the Corporation, Andrijevic retained Kelleran to represent him in legal matters. In one such matter, Kelleran attempted, unsuccessfully, to open a default judgment which had been rendered against Andrijevic (the "Reingold judgment").

After a deterioration in the business relationship between Andrijevic and Kelleran, the two principals agreed to liquidate the Corporation. A few months later, the Corporation sold five acres of undeveloped land for $36,000. However, the

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1 This statement of facts is drawn from the opinions below and from the transcript of proceedings in the Bankruptcy Court.

two did not split the proceeds equally -- Kelleran received $20,000 in cash, while Andrijevic received only $16,000 in promissory notes. According to Andrijevic, his receipt of a smaller share (in notes rather than cash) was to satisfy the Reingold judgment, which had been purchased by the Corporation, and to pay Kelleran for his legal fees.

Kelleran disputes this. He contends that Andrijevic agreed to surrender his ownership interest in the Corporation prior to the sale of the property, and that the $16,000 in notes represented, among other things, payment for the purchase by the Corporation of Andrijevic's stock. Therefore, according to Kelleran, Andrijevic still must repay the Corporation for the Reingold judgment and must pay Kelleran for attorney's fees.

As explained in more detail below, the Bankruptcy Court and the District Court

respectively called Kelleran's version of events "wholly without merit" and "incredible."

In April, 1982, Andrijevic commenced a mechanic's lien foreclosure proceeding against the Corporation in New York State Supreme Court for the County of Erie ("the State Court Action"), in connection with construction work Andrijevic had performed on a certain parcel of property owned by the Corporation. The Corporation counter-claimed for willful exaggeration of a mechanic's lien and breach of contract, and Kelleran sued for attorney's fees allegedly due him in connection with the Reingold judgment. Andrijevic was out of the state when the counterclaims were served on Andrijevic's attorney, and he was not contacted in time to reply. The Corporation then obtained a default judgment. Andrijevic attempted to reopen

the default but the state court denied the motion.

B. Proceedings in the Bankruptcy Court

On February 8, 1984, Andrijevic filed a Petition for an Order of Relief (the "Petition") pursuant to chapter 13 of the United States Bankruptcy Code, 11 U.S.C. §§ 101 - 1330.[2] The filing of this Petition stayed the State Court Action. When the Petition was filed, the state court had determined not to reopen the default judgment but had not yet conducted a damage inquest on the judgment.

The Corporation filed two proofs of claim based on the state court default judgment and Kelleran filed a proof of claim for allegedly unpaid attorney's fees. On June 18, 1984, Andrijevic filed a motion in the Bankruptcy Court pursuant to 11

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2 Jurisdiction in the federal court was founded upon 28 U.S.C. § 1334.

U.S.C. § 502 to disallow the proofs of claim.

The Bankruptcy Court, after holding a full trial on the merits, disallowed Kelleran's and the Corporation's claims. The Court began its discussion by stating that a default judgment requires "careful review" in bankruptcy proceedings, and that "[f]or purposes of determining the allowability of claims, a bankruptcy court may look behind a State Court judgment." (Pet. App. 82A). The Court found ample legal support for this proposition in Pepper v. Litton, 308 U.S. 295 (1939), and Heiser v. Woodruff, 327 U.S. 726 (1946) and in a Second Circuit decision applying those precedents -- Margolis v. Nazareth Fair Grounds & Farmer's Market, 249 F.2d 221 (2d Cir. 1957).

Turning to the merits, the Bankruptcy Court assailed the "meritless claims and questionable professional conduct" of

Kelleran -- whose claims, the Court determined, were "wholly without merit." (Pet. App. 82A). In reaching its conclusion, the Court went so far as to point out "that proofs of claim are filed under penalty of perjury," and that "this court is disturbed that these three proofs of claim which are groundless and were blown beyond reason, apparently to harass the debtor, were filed by a member of the Bar." The Court invited Andrijevic to seek attorney's fees as a result of Kelleran's bad faith filings.

C. The Holding of the District Court

Kelleran and the Corporation appealed the Bankruptcy Court's decision to the United States District Court for the Western District of New York. On October 27, 1986, District Judge Curtin affirmed the order of the Bankruptcy Court. Judge Curtin based his opinion on Pepper, Heiser, and Margolis, stating that

bankruptcy courts "as courts of equity may set aside judgments where they are determined to be fraudulent or otherwise inequitable." (Pet. App. 53A). The District Court further found that the Bankruptcy Court's findings of fact were "reasonable" and based on those findings termed Kelleran's and the Corporation's claims "incredible." (Pet. App. 55A).

D. The Holding of the Court of Appeals

In a split decision, a panel of the United States Court of Appeals for the Second Circuit reversed the orders of both the Bankruptcy Court and the District Court.

1. The Majority Opinion

The panel majority did not quarrel with the findings of the two lower courts that Kelleran's and the Corporation's proofs of claim were groundless. Rather, in reversing those decisions, the panel held that the courts below lacked any

discretion to look behind the state court default judgment. (Pet. App. 11A). The panel based this conclusion on Allen v. McCurry, 449 U.S. 90, 96 (1980), in which this Court held -- in a non-bankruptcy context -- that 28 U.S.C. § 1738 requires "all federal courts to give preclusive effect to state court judgments whenever the courts of the state from which the judgments emerged would do so." 825 F.2d 694.

According to the panel majority, the fact that this case arose under the Bankruptcy Code was of no special significance. The majority rejected as "broad dictum," language that Margolis had borrowed from Pepper to the effect that bankruptcy courts -- as courts of equity entrusted to protect not only the rights of state litigants but creditors as well -- had broad equitable powers to examine the basis of state court judgments. See

Margolis v. Nazareth Fairgrounds & Farmer's Market, 249 F.2d 221, 224 (2d Cir. 1958) (citing Pepper).

Significantly, the panel majority did not cite or discuss Pepper -- which not only formed the basis of the earlier Margolis decision but also was one of the pillars of the lower courts' decisions in this case. Thus, while appearing only to be clarifying an earlier decision of the Second Circuit (Margolis), the panel was in fact launching a frontal assault on Pepper itself.

Without citation to Pepper or this Court's later decision in Brown v. Felsen, 442 U.S. 127 (1979), the panel majority held that there were two (and only two) circumstances in which a bankruptcy court could look behind a state court judgment: "where the judgment was procured by collusion or fraud" or "where the rendering court lacked jurisdiction." (Pet. App.

7A). Because the default judgment in this case could not be pigeon-holed into one of those categories, the panel held that the Bankruptcy Court was paralyzed from looking behind the judgment -- even though (1) the merits were never litigated in state court, (2) the claims were facially outrageous, and (3) innocent creditors not party to the state court litigation would be injured as a result.

2. The Dissenting Opinion

In a lengthy and vigorous dissent, Judge Blumenfeld noted that the "bankruptcy law is a paramount law, which takes precedence over all state laws and proceedings." (Pet. App. 16A). The dissent supported this position by quoting not only the United States Constitution, but also the leading bankruptcy treatise, Collier on Bankruptcy, which states that "virtually all matters involving the allowability of claims and their right

therefore to share in the assets of the debtor ordinarily will be determined by the bankruptcy judge, generally exclusive of all other courts." (Pet. App. 24A) (citing King, 3 Collier on Bankruptcy § 5.02.02 at 502-22-23 (15th ed. 1979)).

Citing Pepper, Judge Blumenfeld emphasized the traditionally broad scope of the bankruptcy court's equitable powers to assure fairness to creditors, including the power to look to the substance, rather than the form, of state court judgments. (Pet. App. 22A). As Judge Blumenfeld noted, these broad equity powers were augmented by Section 105(a) of the Bankruptcy Code, which grants bankruptcy court the authority to issue "any order, process or judgment that is necessary or appropriate to carry out the provisions" of the bankruptcy laws. 11 U.S.C. § 105(a) (emphasis added).

Judge Blumenfeld held that the two narrow exceptions to 28 U.S.C. § 1738

recognized by the majority were unduly restrictive -- and that nothing in the Bankruptcy Code or prior decisions of this Court precluded the existence of other grounds for looking past a state court judgment. Furthermore, Judge Blumenfeld castigated the majority for taking an overly restrictive view of the fraud or collusion exception to res judicata. He argued that Pepper and its progeny provide for "a broader view of a kind of behavior that constitutes fraud that might bring within its embrace the facts of this case." (Pet. App. 41A).

The dissent also criticized the majority for not considering the primary objective of federal bankruptcy laws, i.e., to preserve the assets of the estate for the purposes of achieving an equitable distribution among all creditors. As Judge Blumenfeld noted, while the "action of the state court may represent a sufficient

determination of the rights of the debtor in his dispute with this one particular creditor," this state court determination cannot be paramount "given the interests of the other creditors" whom the federal court is statutorily obligated to protect. (Pet. App. 35A).

The dissent concluded that the broad power of the bankruptcy court to achieve an equitable distribution of the debtor's estate "militates against mechanical application of res judicata to prior state court judgments," in situations in which the underlying claims of the creditor were "facially outrageous" and "wholly without merit." (Pet. App. 39A).

REASONS FOR GRANTING THE WRIT

A. Overview

In a series of recent decisions, this Court has clarified the analysis that a federal court must follow to determine the

preclusive effect of a prior state court judgment outside the bankruptcy context. As this court has recently observed, whether "a particular grant of exclusive jurisdiction justif[ies] a finding of implied repeal of § 1738 . . . will depend on the particular federal statute involved and the nature of the claim or issue involved in the subsequent federal action" -- an inquiry which necessarily depends on the "intent of Congress" when it enacted a "particular" statutory scheme. Marrese v. American Academy of Orthopaedic Surgeons, 105 S. Ct. 1327, 1335 (1985) (emphasis added).

This Court's prior decisions clarify many perplexing questions regarding the preclusive effect to be given a state court

judgment outside the bankruptcy area[3] -- in most cases holding that § 1738 requires federal courts to unswervingly apply res judicata principles to state court judgments.[4] However, the decisions do not address the issue of the preclusive effect to be given a state court judgment in the "particular" context of a bankruptcy proceeding -- where the rights not only of the state court litigants, but also of third party creditors who had no ability to influence the underlying state court

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3 See Allen v. McCurry, 449 U.S. 90 (1980); Kremer v. Chemical Construction Corp., 456 U.S. 461 (1982); Haring v. Prosise, 462 U.S. 306 (1983); Migra v. Warren City School Dist. Bd. of Ed., 465 U.S. 75 (1984); Marrese v. American Academy of Orthopaedic Surgeons, 105 S. Ct. 1327 (1985); Parsons Steel, Inc. v. First Alabama Bank, 106 S. Ct. 768 (1986).

4 See Kremer, 456 U.S. at 461 (Title VII cases); Allen, 449 U.S. at 90 Haring, 462 U.S. at 306 and Migra, 465 U.S. at 75 (Section 1983 cases); Maresse, 105 S. Ct. at 1327 (antitrust cases); Parsons Steel, 106 S. Ct. at 768 (anti-injunction act cases).

action, are determined.

Recognizing that the paramount policy of the bankruptcy laws to assure the equitable distribution of the debtor's estate raises unique concerns, this Court's only recent decision concerning preclusion in bankruptcy, Brown v. Felsen, 442 U.S. 127 (1979), held that, at least in bankruptcy cases, res judicata should be "invoked only after careful inquiry." Id. at 133. Indeed, in Marrese, 105 S. Ct. at 1335 this Court explicitly contrasted bankruptcy from non-bankruptcy cases, noting that the Court in Brown had found a "congressional intent that state judgments would not have claim preclusive effect on [the] dischargeability issue in bankruptcy." The search, therefore, must focus on what Congress intended with respect to state court judgments when it enacted the bankruptcy laws.

Prior to Brown, the only important decisions from this Court which concerned the preclusive effect to be given a state court judgment in bankruptcy were Pepper v. Litton, 305 U.S. 295 (1939) and Heiser v. Woodruff, 327 U.S. 726 (1946). Both of these decisions antedate the Bankruptcy Reform Act of 1978, therefore, they do not provide definitive guidance as to Congressional intent under the Bankruptcy Code. As this Court itself noted in Brown, several commentators have interpreted subsequent legislation as overruling Heiser. See 442 U.S. at 139 n.10.

Moreover, as discussed in more detail at pages 25-32, Pepper, Heiser and Brown are not easily reconcilable to begin with. Pepper appears to argue for a broad construction of the bankruptcy courts' equitable powers to look behind state court judgments, Heiser urges a more narrow construction, and Brown is somewhere in

between. As one frequently cited law review article has noted:

> Whether the bankruptcy court will look behind the judgment and determine whether the claim is without lawful existence is quite another question which we need not consider here at length. Pepper v. Litton plainly says that the bankruptcy court has precisely that power. But Heiser v. Woodruff seemingly rejects Pepper in this respect and holds that the bankruptcy court may not re-examine the issues determined by the judgment itself.

Herzog & Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 Vand. L. Rev. 83, 88-89 (1961)?

The lack of direction from this Court has resulted in diverse and conflicting lower court decisions. Some courts (including the panel majority in this case), relying primarily on Heiser, have held that § 1738 requires bankruptcy courts to apply res judicata subject to two, and only two, narrowly circumscribed exceptions: (1) when the state court lacks

jurisdiction over the parties or the subject matter; or (2) when the state court judgment was procured by collusion or fraud. Other courts, however, including the dissent in this case, have read Pepper and Brown as authorizing the bankruptcy courts, in performing their overriding statutory duty of protecting creditors and equitably distributing the debtor's estate, to look behind a state court judgment and consider the underlying merits of a claim in other circumstances. A more detailed analysis of the lower courts' confusion on this issue appears at pages 33-38 infra.

Respectfully, resolution of these conflicts is urgently needed. An appropriate approach to preclusion in Bankruptcy can be found in Brown, but the lower courts are unsure whether the Brown mode of analysis can be applied to other issues that arise in bankruptcy.

This case presents the Court with an opportunity to clarify and assure the continued vitality of Pepper and Brown, and to determine the applicability of res judicata in the context of bankruptcy proceedings. Certiorari should be granted because of the importance and recurring nature of this federal question and the need for clarification of the Court's prior decisions in this area to resolve the conflicting lower court decisions that have resulted.

B. The Lack of Clarity In This Court's Prior Decisions

The three leading cases discussing the power of a bankruptcy court to look behind a state court judgment and to reevaluate the underlying merits of a claim are Pepper v. Litton, 308 U.S. 295 (1939), Heiser v. Woodruff, 327 U.S. 726 (1946), and Brown v. Felsen, 442 U.S. 127 (1979). Attempts at reconciling the sometimes contradictory

pronouncements in the three cases have proven difficult.

Pepper, like this case, concerned the bankruptcy court's power to allow or disallow claims that have been reduced to judgment by a state court. The case involved a scheme by Litton, the controlling shareholder of the Dixie Splint Coal Company, to avoid Dixie's payment of a debt owed by Dixie to Pepper. The scheme depended largely upon a substantial (though baseless) judgment that Litton, as controlling shareholder, had caused Dixie to confess in his favor. This judgment technically made Litton a creditor of the corporation. After Dixie entered bankruptcy, Pepper (who also had a claim against the corporation) sought to have the bankruptcy court look behind the confessed judgment to determine that there was no basis for it. Pepper, 308 U.S. at 296-302.

After reviewing the specific provisions of the Bankruptcy Act of 1898 that granted broad equity powers to the bankruptcy courts, 308 U.S. at 304-05, this Court concluded that

> a bankruptcy court has full power to inquire into the validity of any claim asserted against the estate and to disallow it if it is ascertained to be without lawful existence. [citation omitted] And the mere fact that a claim has been reduced to judgment does not prevent such an inquiry. As the merger of a claim into a judgment does not change its nature so far as provability is concerned [citation omitted], so the court may look behind the judgment to determine the essential nature of the liability for purposes of proof and allowance.[5]

308 U.S. at 305-06 (citations omitted) (emphasis added). The Court in Pepper thus found a broad bankruptcy exception to the

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5 Congress may have actually codified this language in Pepper by enacting 11 U.S.C. § 502(b)(1), which provides that the bankruptcy court must disallow a claim if "such claim is unenforceable . . . under any agreement or applicable law. . . ."

rules of res judicata (otherwise known as "claim preclusion"). The Court held that the bankruptcy court could review the underlying merits to determine whether the confessed judgment reflected a genuine debt and whether, if it did, the claim should nevertheless be disallowed or subordinated. Id., 308 U.S. at 302-03.

Reaching the merits, this Court concluded that Litton's fraudulent scheme made "the necessity of equitable relief against that fraud . . . insistent." Id., 308 U.S. at 312. But the Court's opinion makes it clear that, wholly apart from the existence of fraud, equitable relief was appropriate because of other equitable considerations. In particular, the Court held that "astute legal maneuvering" by the controlling shareholder to the detriment of creditors, even if it did not amount to fraud, "alone would be a sufficient basis for the exercise by [the court] of its

equitable powers." Id. (emphasis added). The Court thus made it abundantly clear that a bankruptcy court could go behind a state court judgment not only to remedy fraud, but also "according to the equities of the case." Id. at 304.

Pepper was followed seven years later by Heiser v. Woodruff, 327 U.S. 726 (1946). Heiser, like Pepper, involved the allowability of a claim in bankruptcy. In contrast to Pepper, which involved claim preclusion, Heiser involved issue preclusion (otherwise known as "collateral estoppel"). The debtor asserted in Heiser that a prior state court judgment had been "procured by fraud, that is, by perjured allegations in the complaint in the suit in which the judgment was rendered, and by perjured testimony. . . ." Id., 327 U.S. at 728. The Court held that the issue of fraud could not be relitigated in the

EDITOR'S NOTE

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bankruptcy court because to allow such relitigation would be contrary to

> the generally recognized public policy that there must be some end to litigation and that when one appears in court to present his case, is fully heard, and the contested issue is decided against him, he may not later renew the litigation in another court.

327 U.S. at 733 (emphasis added). Assuming it is still good law, Heiser stands for the proposition that an issue, once fully litigated and decided by a state court, should not be relitigated in the bankruptcy court. Even Heiser, however, recognized Pepper's rule that a bankruptcy court could consider the underlying merits of a claim where the state court had not actually considered the merits before entering judgment. Heiser, 327 U.S. at 732.

The Court's next significant decision in this line of cases came thirty-three years later in Brown v. Felsen, 442 U.S 127 (1979). Brown held that the principle of

res judicata (claim preclusion) did not prevent the bankruptcy court from considering anew whether a debt was dischargeable in bankruptcy even though that issue was, or could have been litigated in a prior state court proceeding. 442 U.S. at 138-39. As explained in Marrese, the Court in Brown found a "congressional intent that state judgments would not have claim preclusive effect on [the] dischargeability issue in bankruptcy." 105 S. Ct. at 1335.

The Court in Brown thus found in the bankruptcy laws an exception to res judicata. It also suggested the possibility of an exception to collateral estoppel, reserving for future consideration the question "whether a bankruptcy court adjudicating a § 17 question should give collateral-estoppel effect to a prior state judgment." Brown, 442 U.S. at 139 n.10. As this Court noted,

such an exception would be contrary to Heiser, but an argument in favor of such an exception could be found in the 1970 amendments to the Bankruptcy Act. Id.

Brown, which is more consistent with the Court's approach in Pepper and which expressly questions the continued vitality of Heiser in certain contexts, teaches that there is no bright-line test by which a bankruptcy court may determine the preclusive effect of a prior state court judgment. Instead, bankruptcy courts should undertake an analysis of the policies that underlie particular sections of the bankruptcy laws that are at issue to determine whether the bankruptcy question being raised is "the type of question Congress intended that the bankruptcy court would resolve." Brown, 442 U.S. at 138. Justice Rutledge argued for precisely such a balancing approach in his concurring opinion in Heiser. 327 U.S. at 741-42.

Understandably, the lack of clear claim preclusion principles in the bankruptcy context has resulted in inconsistent lower court decisions and a hopelessly muddied state of the law.

C. Diverse and Inconsistent Lower Court Decisions

There is no question that, in the ordinary case, the equitable principles of res judicata embodied in 28 U.S.C. § 1738 apply in a bankruptcy proceeding. There is likewise no question that, in an appropriate case, the bankruptcy court may look behind the state court judgment and independently determine the merits of the claim. The lower courts, have been inconsistent in defining the type of circumstances that would warrant a departure from the application of res judicata in a bankruptcy proceeding.

The panel majority in this case took an extremely narrow view of those

circumstances. According to the panel, fraudulent procurement of the state court judgment and lack of jurisdiction are the only circumstances which would warrant an independent review by the bankruptcy court of the prior state court proceeding. A number of lower court decisions, primarily relying on Heiser, support this limited view of the bankruptcy court's power. See, e.g., Browning v. Navarro, No. 86-1444, slip op. (5th Cir. Aug. 26, 1987); Kapp v Naturelle, Inc., 611 F.2d 703, 707-08 (8th Cir. 1979), In re National Structures, 74 Bankr. 986 (Bankr. E.D. Wis. 1987); In re Bowers, 69 Bankr. 822 (Bankr. D. Conn. 1987).

Other lower court decisions, however, have taken a much broader view of the bankruptcy court's power to review a prior state court determination. For the most part, these decisions rely on Pepper. Thus, the bankruptcy judge in In re Bus

Stop, Inc., 3 Bankr. 26 (Bankr. S.D. Fla. 1980), held that although Pepper and the Second Circuit's earlier decision in Margolis "dealt with judgments establishing fraud", he saw "no reason to limit the holding in these cases to that narrow issue." Id. at 27. Similarly, in In re Timenterial, Inc., 3 Collier Bankr. cas (MB) 517 (D. Conn. 1975), the district court cited Pepper for the proposition that bankruptcy courts "may look behind the judgment to determine the essential nature of the liability for purposes of proof and allowance." Id. at 519 (emphasis in original). Or, as one court put it, while res judicata may apply in bankruptcy cases, "Congress is empowered to authorize the bankruptcy courts to apply the policies of federal bankruptcy law to bankruptcy matters," and where such policies are implicated, the bankruptcy court should "look behind the state court judgment to

the nature of the claim on which it was rendered." In re Hewitt, 16 Bankr. 973, 978 (Bankr. D. Alaska 1982) (holding that Bankruptcy Code enabled bankruptcy court to disregard state court foreclosure judgment); accord Valente v. Savings Bank of Rockville, 34 Bankr. 362, 366 (D. Conn. 1983) (bankruptcy law's policy of allowing debtors to cure a mortgage default is paramount to state law).

Some courts have held that when determining whether to give preclusive effect to a prior state court judgment, the court must determine whether any bankruptcy statute "expressly or impliedly prevents the bankruptcy court from applying the same preclusive effect" to a state court judgment as a state court. In re All-American of Ashburn, Inc., 56 Bankr. 196 (Bankr. N.D. Ga. 1986); accord In re Byard, 47 Bankr. 700, 701 (Bankr. M.D. Tenn. 1985); In re Fazio, 41 Bankr. 865

(Bankr. E.D. Pa. 1984). Moreover, at least one decision has held that a bankruptcy court may disregard a state court judgment on public policy grounds. In re Hamlett, 63 Bankr. 492 (Bankr. S.D. Fla. 1986)

The confusion generated by these conflicting general pronouncements is compounded when the courts have attempted to apply them in the context of a default or confessed judgment -- judgments which by definition are not litigated on the merits. A number of lower courts have interpreted Heiser to hold that a prior default or confessed judgment is binding on the bankruptcy court unless the default or confessed judgment fit neatly into one of the two pigeon-hole exceptions. See, e.g., Kapp v. Naturelle, Inc., 611 F.2d 703, 707-08 (8th Cir. 1979); In re Hamlett, 63 Bankr. 492 (Bankr. N.D. Fla. 1986); In re Bently, 47 Bankr. 269 (Bankr. S.D.N.Y. 1985).

Other courts, however, have taken the opposite point of view. They hold that, if the prior judgment was by default or by confession, the bankruptcy court is not necessarily bound by res judicata. See, e.g., Baird v. Smith (In re Continental Engine Co.), 234 F. 58 (7th Cir. 1916); In re Souders, 75 Bankr. 427 (Bankr. E.D. Pa. 1987); In re Giorgio, 62 Bankr. 853 (Bankr. D.R.I. 1986); In re Lockwood, 14 Bankr. 374 (Bankr. E.D.N.Y. 1981); In re Tapp, 16 Bankr. 318 (Bankr. D. Alaska 1981). This view is supported by the leading treatise on bankruptcy law, which states that the bankruptcy court's equitable power to look behind a state court judgment is "applicable especially to judgments by default or pro confesso." King, 3 Collier on Bankruptcy § 63.07 at 1813 (14th ed. 1940); see also King, 3 Collier on Bankruptcy ¶ 502-02 at 502-22-23 at n.8 (15th ed. 1977) (bankruptcy court only

court empowered to determine allowability of claim). As the Court stated in In re Souders, 75 Bankr. 427 (Bankr. E.D. Pa. 1987), in which the dollar amount of a confessed judgment bore no resemblance to the debtor's actual liability, "it is permissible for bankruptcy courts to look behind state court judgments in considering defenses which would bar any recovery. Hence the doctrine of res judicata is inapplicable." Id. at 432.

From the above -- as well as the sharp diversion of views on the Second Circuit panel itself -- it is clear that this Court's guidance is needed on this important and frequently encountered federal issue.

D. The Majority Decision Is Wrong

Judge Blumenfeld's dissenting opinion provides the better reasoned view of the bankruptcy court's power to look behind state court judgments when exercising their

statutory function to allow or disallow claims. 11 U.S.C. § 502. This view not only is fully supported by this Court's prior decisions in Pepper, Heiser and Brown but, more importantly, is absolutely necessary to protect the bankruptcy courts' core function "to insure an equitable distribution amongst [creditors] of the debtor's assets." Myers v. Matley, 318 U.S. 622, 627 (1943). Unless the bankruptcy court has a measure of discretion, the rights of creditors who were absent from the state court proceeding will be unfairly compromised. This is especially so where, as here, the state court judgment was not a determination on the merits -- but was the result of a mere procedural default.

Nothing in the Court's prior decisions countenances a view that fraud or lack of jurisdiction are the only two exceptions to § 1738. To the contrary, even Heiser,

which took the most restrictive position on the ability of bankruptcy courts to review state court proceedings, recognized that

> [i]n appropriate cases, acting on equitable principles, [the court] may also subordinate the claims of one creditor to those of others in order to prevent the consummation of a course of conduct by the claimant which, as to them, would be fraudulent or otherwise inequitable.

328 U.S. at 733 (emphasis added). One cannot square the panel majority's decision with the plain language of Heiser. The majority takes the words "or otherwise inequitable" right out of the case.

Pepper and Brown likewise support a more expansive view of the bankruptcy courts' powers. Thus, while a fraud had clearly occurred in Pepper, this Court took great pains to emphasize that its decision would be the same even if Litton's conduct had not been fraudulent. Thus, the Court stated that even if all that had occurred was the controlling shareholder's "astute

legal maneuvering to acquire most of the assets of the bankrupt" at less than fair value, that "alone would be a sufficient basis for the exercise by the District Court of its equitable powers in disallowing Litton's claim." 308 U.S. at 312. While the existence of fraud made the case for relief "insistent", it was not, according to the Pepper Court, a prerequisite.

Similarly, in Brown, this Court rejected any formalistic approach to the application of res judicata in bankruptcy proceedings. Rather, the bankruptcy court should weigh "the interests served by res judicata" and "the policies of the Bankruptcy [Code]," to determine whether circumstances were present which would justify reviewing the state court judgment. 442 U.S. at 13. In the bankruptcy context, res judicata should be "invoked only after careful scrutiny." Id.

This is not to deny that res judicata is an important value. The policy of repose embodied in res judicata is important and, as such, should be given due consideration by the bankruptcy court in determining whether the equities favor looking behind the state court judgment. As Justice Rutlege stated -- in a concurrence in Heiser that is fully supported by this Court's analysis in Brown -- res judicata "cannot be irrelevant to what equitable principles may require the bankruptcy court to do in disposing of the claim." 327 U.S. at 742. That res judicata is relevant, however, does not mean that it is dispositive.

In holding to the contrary -- and limiting the exceptions to § 1738 to fraud and lack of jurisdiction -- the panel majority relied primarily on a non-bankruptcy case, Allen v. McCurry, 449 U.S. 90 (1986). The panel's reliance on

Allen is misplaced, however, because, as this Court held in Marrese, exceptions to § 1738 depend on the "particular federal statute" at issue. The Court's judgment in Allen, in a Section 1983 case, is of little import to whether Congress intended, in enacting the bankruptcy laws, to invest bankruptcy courts with a broader discretion to examine the bases of state court judgments. 105 S. Ct. at 1335.

The statutory scheme embodied in the Bankruptcy Code leaves little doubt that Congress did intend to empower bankruptcy courts with at least some modicum of discretion to re-examine state court judgments. Thus, bankruptcy courts have the sole power to allow or disallow claims under 11 U.S.C. § 502.[6] In furtherance of that function -- which is at the very core of what bankruptcy courts do -- Congress

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6 See supra note 5 (discussing Code § 502(b)(1)).

empowered the bankruptcy court to "issue any order, process or judgment necessary or appropriate to carry out" its mandate. 11 U.S.C. § 105(a) (emphasis added). This broad, overarching grant of statutory authority -- which had not been enacted when claims in Pepper, Heiser and Brown arose -- clarifies any ambiguity which may have existed at the time those cases were decided. Section 105(a) enables the bankruptcy court to issue any order consistent with equitable principles in furtherance of its statutory function to determine claims under Section 502. To the extent § 1738 may interfere with the court's performance of its statutory duty, it is § 1738 -- and not the Bankruptcy Code -- which must give way.

This analysis is fully supported by the general purposes of the Bankruptcy Code as well. As the legislative history of the Code makes clear: "Bankruptcy is designed

to provide an orderly liquidation procedure under which all creditors are treated equally." H.R. Rep. No. 595, 75th Cong. 1st Sess. 340 (1978) (emphasis added). It would be impossible for bankruptcy courts to serve this function of treating "all creditors equally" if they were divested of any discretion to look at the merits of a state court judgment. It is at war with the very purpose of the statute to allow a particular creditor whose claim is "wholly without merit" and "incredible" to disadvantage other creditors simply because the debtor defaulted in state court.

This action presents the classic case requiring such intervention. In factual findings left undisturbed by the panel majority, the Bankruptcy and District Court each found that the proofs of claim filed by Kelleran and the Corporation were absurd. To allow such frivolous claims to prevail -- and thereby jeopardize the

legitimate rights of Andrijevic's other creditors -- would be to turn the paramount policy of the bankruptcy laws on its head. Here, as in Brown, "neither the interests served by res judicata, the process of orderly adjudication in the state courts, nor the policies of the Bankruptcy [Code] would be well served by foreclosing petitioner from submitting additional evidence to prove his case." 442 U.S. at 132.

CONCLUSION

For the reasons stated, a petition for a writ of certiorari should be issued to the United States Court of Appeals for the Second Circuit.

Dated: November 2, 1987

Respectfully submitted,

EDWIN R. ILARDO
20 Buffalo Street
Hamburg, New York
14075
(716) 649-2880

Of Counsel

WILLIAM H. GARDNER
Hodgson, Russ, Andrews,
Woods & Goodyear
Suite 1800
One M&T Plaza
Buffalo, New York
14203
(716) 856-4000

Attorney for Petitioner
Slavko Andrijevic

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 911 August Term, 1986

(Argued March 10, 1987 Decided August 4, 1987)

Docket No. 88-7995

C. RUSSELL KELLERAN, JR.,
EIGHTEEN MILE CORPORATION,

Plaintiffs-Appellants,

v.

SLAVKO ANDRIJEVIC, a/k/a
AL ANDRIE,

Defendant-Appellee.

B e f o r e: MESKILL and NEWMAN, Circuit Judges, and BLUMENFELD* District Judge.

Creditors appeal from a judgment entered in the United States District Court

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* Honorable M. Joseph Blumenfeld, United States District Judge for the District of Connecticut, sitting by designation.

for the Western District of New York, Curtin, C.J., affirming a judgment entered in the United States Bankruptcy Court, McGuire, J., that disregarded the preclusive effect of a New York state court default judgment obtained by one of the creditors against the debtor and disallowed the creditors' claims.

Reversed and remanded. Judge Blumenfeld dissents in a separate opinion.

E. THOMAS JONES, Buffalo, New York (C. Russell Kelleran, Jr., Buffalo, New York, of counsel), for Plaintiffs-Appellants.

EDWIN R. ILARDO, Hamburg, New York, for Defendant-Appellants.

MESKILL, Circuit Judge:

This is an appeal from a judgment entered in the United States District Court for the Western District of New York, Curtin, C.J., affirming a judgment entered

in the United States Bankruptcy Court, McGuire, J., that disregarded the preclusive effect of a state court default judgment fixing the liability of the debtor-appellee, Andrijevic, to one of the creditors-appellants, Eighteen Mile Corporation, and disallowed the creditors' claims.

This appeal presents the issue whether the bankruptcy court's equitable powers permit it to disregard the preclusive effect of a state court default judgment where the judgment was obtained by a creditor without fraud or collusion, but the bankruptcy court finds the creditor's claims to be "wholly without merit."

Reversed and remanded.

BACKGROUND

The relevant facts may be summarized briefly. Andrijevic and Kelleran formed Eighteen Mile Corporation for the purpose

of buying and developing real estate. Following a deterioration in the relationship between Andrijevic and Kelleran, Andrijevic filed a mechanic's lien on certain real estate owned by Eighteen Mile. Eighteen Mile timely filed an answer denying Andrijevic's claim and counterclaimed for breach of contract and willful exaggeration of a mechanic's lien. Creditor-appellant Kelleran brought a separate suit against Andrijevic for unpaid legal fees.

Andrijevic defaulted on the counterclaims by not serving a reply. Subsequently, Andrijevic tried to reopen the default judgment, but was unsuccessful. The New York Supreme Court (Erie County) entered judgment in favor of Eighteen Mile with respect to the counterclaims as to liability and scheduled a damages inquest. Before the damages inquest could take

place, Andrijevic commenced the instant bankruptcy proceeding which automatically stayed all state proceedings, including the damages inquest.

Kelleran and Eighteen Mile filed proofs of their claims in the bankruptcy court, with Eighteen Mile seeking to enforce the state court default judgment. The bankruptcy court, however, found that the creditors' claims were "wholly without merit" and refused to give the state court default judgment binding effect. The bankruptcy court found for Andrijevic as to each of the creditors' claims and disallowed them. The district court affirmed, finding the creditors' claims to be "incredible." J. App. at 144. This appeal followed.

DISCUSSION

"Congress has specifically required all federal courts to give preclusive

effect to state-court judgments whenever the courts of the State from which the judgments emerged would do so . . . ." Allen v. McCurry, 449 U.S. 90, 96 (1980) (citing 28 U.S.C. § 1738 (1982)). Bankruptcy courts fall within Congress' mandate. See, e.g., In the Matter of Farrel, 27 B.R. 241, 243 (Bkrtcy. E.D.N.Y. 1982). The bankruptcy court, therefore, was bound to give preclusive effect to the default judgment obtained in the state court by Eighteen Mile to the same extent as would a New York court.

In New York, when a party defaults by failure to answer and the court orders an inquest as to damages, the defaulting litigant may not further contest the liability issues. Amusement Business Underwriters v. American International Group, 66 N.Y.2d 878, 498 N.Y.S.2d 760, 762, 489 N.E.2d 729 (1985); Rokina Optical

Co. Inc. v. Camera King, Inc., 63 N.Y.2d 728, 480 N.Y.S.2d 197, 198-99, 469 N.E.2d 518 (1984); Metropolitan Property & Liability Ins. v. Cassidy, 127 Misc. 2d 641, 486 N.Y.S.2d 843, 847 (N.Y. Sup, Ct. 1985). The bankruptcy court, therefore, was bound to the liability determinations in the state judgment unless an exception existed to prevent operation of the judgment's preclusive effect. Bankruptcy courts may look beyond a state court default judgment where the judgment was procured by collusion or fraud, Margolis v. Nazareth Fair Grounds & Farmers Market, 249 F.2d 221, 223-25 (2d Cir. 1957), or where the rendering court lacked jurisdiction, Heiser v. Woodruff, 327 U.S. 726, 736 (1946). Andrijevic concedes that neither of these exceptions applies here.

Instead, Andrijevic would have us create a third exception. Kelleran and

Andrijevic were business partners and, in addition, Kelleran, an attorney, represented Andrijevic on various legal matters unrelated to their business relationship. Andrijevic contends that the previous attorney/client relationship between the parties should somehow excuse Andrijevic's default. This contention is untenable. Andrijevic concedes that Kelleran was not acting as his attorney in the state court action, that Andrijevic did not look to Kelleran for assistance therein and that Kelleran did not prevent Andrijevic in any way from timely responding to the counterclaims. We, therefore, reject Andrijevic's argument that the suggested exception be recognized.

The courts below relied on a somewhat different theory in disregarding the preclusive effect of the state court judgment. Citing broad dictum from

Margolis and its progeny discussing the equitable powers of the bankruptcy court, each court summarily determined, without specific factual or legal analysis, that Eighteen Mile's claims were so outrageous as to warrant independent review of the liability issues decided in the state court. See J. App. at 133 (bankruptcy court's analysis); J. App. at 141-45 (district court's analysis).

The lower courts' application of Margolis to the instant case was error. Margolis and its progeny speak only to the bankruptcy court's broad equitable power to remedy fraudulent procurement of default judgments. The Margolis line does not alter section 1738's requirement that bankruptcy courts respect lawfully obtained state court judgments. Andrijevic concedes that the only established exceptions to this rule are not applicable in this case.

While the record strongly suggests that the merits of Eighteen Mile's claims are doubtful, Andrijevic should have attacked these claims in the state court. Bankruptcy proceedings may not be used to re-litigate issues already resolved in a court of competent jurisdiction. Teachers Ins. & Annuity Ass'n of America v. Butler, 803 F.2d 61, 66 (2d Cir. 1986). The courts below erred in refusing to give preclusive effect to the state court judgment.

The Bankruptcy Court's Damages Findings

Andrijevic contends that even if the courts below erred in disregarding the binding effect of the default judgment, they may be upheld on another ground. The default judgment spoke only to liability; it expressly contemplated a damages inquest that never took place. Andrijevic, therefore, contends that the bankruptcy

court's analysis of the damages issues properly before it, in which the elements of the damages claims were deemed "facially outrageous" and summarily rejected, J. App. at 127, should be affirmed because these findings were not barred by the state proceedings.

While we agree that the state proceedings did not bar litigation of the damages issues, Rokina Optical, 480 N.Y.S.2d at 198-99, we nonetheless remand to the bankruptcy court for a reevaluation of these issues.[1] The bankruptcy court's analysis of damages was undertaken only after it had disallowed the claims on the merits; the bankruptcy court expressly stated that its analysis of the damages issues was unnecessary in light of its resolution of the liability issues. J. App. at 127. Moreover, the bankruptcy court's analysis of damages improperly

incorporated some of its findings regarding liability, a matter already resolved by the state court default judgment.

The judgment of the district court is reversed.[2] The district court is instructed to remand the matter to the bankruptcy court for a rehearing on damages giving res judicata effect to the liability judgment of the state court.[3]

FOOTNOTES

1 Andrijevic claims that Eighteen Mile's judgment on its claim for willful exaggeration of a mechanic's lien should not be allowed without a hearing for a determination of the factual question of willfulness. Br. of Appellee at 12-13. Andrijevic, however, was put on notice of this claim in the creditor's answer and counterclaim in the state court proceeding, J. App. at 19-20, but defaulted by failing to respond to it. The issue, therefore, may not be re-litigated Mazzarella Building Co. v. Loup Realty Corp., 51 A.D.2d 672, 377 N.Y.S.2d 993, 994 (N.Y. App. Div.), leave to appeal dismissed, 39 N.Y. 820, 385 N.Y.S.2d 766, 351 N.E.2d 433 (1976). The damages recoverable under section 39-a of the New York State Lien Law will be determined in the bankruptcy court on remand.

2 We need not address the implications of our decision on Andrijevic's right to appellate review of the default judgment in state court. He filed his bankruptcy petition without seeking review by a New York court, an avenue that he was entitled to pursue. See generally 7B N.Y. Civ. Prac. L. & R. § 5511, Practice Commentaries (McKinney 1978) (default may be challenged by making motion to vacate it and then appealing from order denying the motion). Likewise, Andrijevic failed to move the

bankruptcy court to stay its proceedings to permit him to seek such review. Finally, he has not contended that the bankruptcy proceedings in any way denied him his appellate rights.

3 Our decision does not disturb the bankruptcy court's disallowance of Kelleran's claim for legal fees. That claim was brought as a separate action by Kelleran in the state court, was stayed at the discovery stage by institution of the instant bankruptcy proceedings, and is not of the type that would be governed by res judicata in the context of the state court default at issue here.

BLUMENFELD, District Judge (dissenting):

I cannot agree with my fellow members of the panel that the entry by the state court of this "default judgment" against the appellee on counterclaims brought by one of the appellant-creditors precludes the bankruptcy court from looking behind the state court determination and disallowing the claims in the bankruptcy proceeding. To require a mechanical application of the doctrine of res judicata and the seeming dictate of 28 U.S.C. § 1738 ignores the broad equitable powers of the bankruptcy court to take actions necessary to achieve an equitable distribution of the bankrupt's estate among creditors. Although the federal bankruptcy power is "a field whose boundaries may not yet be fully revealed," Continental Ill. Nat'l Bank v.

Chicago, Rock Island and Pac. Ry. Co., 294 U.S. 648, 671 (1935), in this instance, given the bankruptcy court's broad equity powers, it is clear that a number of factors combine to support the bankruptcy judge's decision to go behind the state court determination. These will be discussed separately.

I. The Nature of Bankruptcy Court Power

A. Paramountcy of Bankruptcy Law

The power of the bankruptcy court stems from a grant of authority in Article I of the Constitution, which grants to Congress the power "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const. art. I, § 8, cl. 4. The bankruptcy law is a paramount law, which takes precedence over all state laws and proceedings. Vanston Bondholders Protective Comm. v.

Green, 329 U.S. 156 (1946); Kalb v. Feurstein, 308 U.S. 433 (1940). It is a power intended to be applied uniformly throughout the nation in the disposition of claims against insolvent estates. For instance, "[i]n determining what judgments are provable and what objections may be made to their proof, and in determining the extent to which the inequitable conduct of a claimant[,] in acquiring or asserting his claim in bankruptcy, requires its rejection or its subordination to other claims . . . , the bankruptcy court is defining and applying federal, not state, law." Hasier v. Woodruff, 327 U.S. 726, 732 (1946).

B. Equitable Powers Limit the Principle of Res Judicata

In exercising this paramount power, the bankruptcy courts are "essentially courts of equity, and their proceedings inherently proceedings in equity." Local

Loan Co. v. Hunt, 292 U.S. 234, 240 (1934). Bankruptcy proceedings are to be "administered in accord with the general principles and practice of equity." In re Lustron Corp., 184 F.2d 789, 793 (7th Cir. 1950), cert. denied, 340 U.S. 946 (1951). See also Pepper v. Litton, 308 U.S. 295 (1939); Continental Ill. Nat'l Bank v. Chicago, Rock Island and Pac. Ry. Co., 294 U.S. 648 (1935); Corley v. Cozart, 115 F.2d 119 (5th Cir. 1940); Larson v. First State Bank, 21 F.2d 936 (8th Cir. 1927). The bankruptcy court is charged with preventing injustice and unfairness. By statute, "the bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a).

Given the broad equitable powers of the bankruptcy court, the majority is overly strict in its view of the grounds

for collateral attack on a prior state court judgment in bankruptcy court. In its view, a prior state court judgment must be treated as res judicata unless the judgment is procured through "fraud or collusion," or the issuing court lacked jurisdiction. Since the majority considers that the present case does not raise either of these two exceptional circumstances,[1] it concludes that the bankruptcy court is without power to look behind the state court judgment and disallow the claims based upon it. However, the very structure of the bankruptcy laws, as well as the breadth of the bankruptcy court's equity power to do justice and avoid substantial unfairness in allowing or disallowing claims, supports the view that the bankruptcy court was within its power in disallowing these claims, and that these two types of exceptions are not exclusive.

1. Structure of Bankruptcy Laws

That the bankruptcy court's mandate to do equity is far broader than that suggested by the majority is evidenced by the very structure and extent of the court's authority to dispose of creditors' claims. "The power of the bankruptcy court to subordinate claims or to adjudicate equities arising out of the relationship between the several creditors is complete. . . . [T]he theme of the Bankruptcy Act is equality of distribution." Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941). Commencing with the court's power to issue automatic stays pursuant to 11 U.S.C. § 362, as it did in the present case, and progressing through its power to disallow, see § 502, subordinate, see § 510(c), and discharge claims, see § 523, the bankruptcy court's control over the bankrupt's estate is plenary. It has a

variety of tools with which it can freely exercise its equitable powers to affect the particularities of an individual debtor-creditor relationship or the relationship among creditors. Under the doctrine of equitable subordination, for instance, a bankruptcy court may subordinate a particular claim if it finds that the creditor's claim, while not lacking a lawful basis, nonetheless results from inequitable behavior on the part of that creditor. See 11 U.S.C. § 510(c). See also In re W.T. Grant Co., 699 F.2d 599 (2d Cir. 1983) (Friendly, J.); Herzog & Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 Vand. L. Rev. 83 (1961).

2. Equity Power to Disallow Claims is Broad

The case law provides strong support for a broad view of the bankruptcy court's

authority to determine whether to allow or disallow a particular claim that has been reduced to judgment in state court. "It has long been a basic function of the bankruptcy court, both by reason of its equitable powers and the bankruptcy statute, to pass upon the validity of creditors' claims." In re Farrell, 27 B.R. 241, 245 (Bankr. E.D.N.Y. 1982). The bankruptcy court "in passing on allowance of claims sits as a court of equity. . . . In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done, in administration of the bankrupt estate." Pepper v. Litton, 308 U.S. 295, 307-08 (1939). This sifting includes "full power to inquire into the validity of any claim asserted against the estate and to disallow it if it is

ascertained to be without lawful existence. And the mere fact that a claim has been reduced to judgment does not prevent such an inquiry." Pepper, 308 U.S. at 305 (citations omitted) (emphasis supplied). These broad powers have been "invoked to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." Pepper, 308 U.S. at 305. See also In re Century Vault Co., 416 F.2d 1035 (3d Cir. 1969). As one learned treatise has noted:

> It is the bankruptcy court, through its bankruptcy judge, which is to determine whether or not a claim is to be allowed or disallowed, i.e., whether the content of the claim is within the reach of section 502(b). As it is contemplated under the Code as well as it was under the former Act that the determination of the allowability of claims is within the province of the bankruptcy judge, it follows that virtually all matters involving the allowability of claims and their

> right therefore to share in the assets of the debtor ordinarily will be determined by the bankruptcy judge, generally exclusive of all other courts.

3 Collier on Bankruptcy ¶ 502.02, at 502-22-23 (15th ed. 1979).

3. Relationship Between Bankruptcy Court's Power and Res Judicata Doctrine

It is clear that the principles of res judicata are not to be mechanically applied in the bankruptcy context. To the extent a prior state court judgment is recognized in bankruptcy court, such recognition is not based "upon a technical application of res judicata doctrine, but upon the court's recognition that the equitable considerations underlying that doctrine require its application in the absence of compelling circumstances to the contrary." Margolis v. Nazareth Fair Grounds & Farmers Mkt., 249 F.2d 221, 224 (2d Cir. 1957). As Justice Rutledge reasoned:

> If . . . the bankruptcy court has power to reject claims, even when previously allowed, "in whole or in part 'according to the equities of the case,'" . . . the bankruptcy court in the allowance or rejection and ordering of claims shall not be bound by any broad or rigid rule of res judicata.

Heiser v. Woodruff, 327 U.S. 726, 741 (Rutledge, J., concurring) (citations omitted) (emphasis supplied). "A state court judgment does not have res judicata effect because the bankruptcy judge is the only authority that can decide if a claim is allowable, and the judge may look behind the judgment to determine if a contractual basis exists for the claim." 3 Collier on Bankruptcy ¶ 502.02, at 502-22-23 n.8 (citations omitted).

The relationship between res judicata and the bankruptcy court's equity power is thus well captured by the reasoned dicta in Margolis v. Nazareth:

> To the extent that equitable principles require reexamination by the bankruptcy court of the bases for the judgment where these bases have been or could have been previously adjudicated the doctrine of res judicata is inapplicable in bankruptcy proceedings.

249 F.2d at 224.

II. The Character of the State Court Ruling

Given these broad powers of equity and the nature of the relationship between the court's equity power and the doctrine of res judicata, one set of factors in particular weighs in favor of the bankruptcy court invoking its equity power to disallow the claims here in issue even though they have proceeded to judgment in state court. These factors relate to the character and content of the judgment here at issue, as opposed to its form. In this case, "judgment" was issued on the basis of a default by the debtor, and then as to liability only. It was done upon the

failure of the debtor to comply with a procedural rule, and after no litigation on the merits. Therefore, the judgment operated as a penalty upon the debtor for his failure to comply with this state rule of procedure, and did not determine the substantive rights of the parties.

A. Default Judgments Deserve Close Scrutiny

As a general matter, judgments which may be characterized as default judgments deserve closer scrutiny by the bankruptcy court than would otherwise be the case. "Especially in the case of a pre-bankruptcy judgment, it may at times be proper to consider whether judgment followed vigorous litigation by the debtor." 1B J. Moore, Moore's Federal Practice ¶ 0.419[3.-6], at 675. Similarly, Justice Stone, writing for the court in Heiser v. Woodruff, stated that res judicata is to be given effect

"when one appears in court to present his case, is fully heard, and the contested issue is decided against him." 327 U.S. at 733 (emphasis added). Thus, the subordination of the doctrine of res judicata to the paramount equitable powers of bankruptcy courts is "'applicable especially to judgments by default or pro confesso.'" Margolis v. Nazareth, 249 F.2d at 224 (citations omitted).

B. Procedural Character of Determination Here at Issue

The bankruptcy court, in exercising its equitable discretion, should of course give due consideration to the state's interest in having its court's determinations recognized. This interest, however, must be balanced against the bankruptcy court's interest in reaching a just and equitable result in the overall circumstances of the case. In determining

whether to give effect to a state court ruling, the bankruptcy court may appropriately consider whether that ruling was the enforcement of a state procedural rule or was a finding of the existence of an ingredient to the establishment of a substantive right.

In this case, the state's interest in having that which it regards as a final judgment enforced can only be regarded as minor. Here, exacting scrutiny shows that a default was entered against the debtor on two counterclaims essentially as a penalty for the debtor's failure to timely answer them. A motion to set aside the default was denied after oral argument and the consideration of affidavit evidence submitted by the debtor, and judgment, as to liability only, was then entered against the debtor on these counterclaims. Although the appellants contend otherwise,

there is no clear indication that the state court judge, in denying the motion to set aside, made any determinations as to the possible merits of the debtor's defense to the claims or made any factual findings going to the merits. All that is clear is that the court found inadequate the debtor's proffered excuse for failing to timely respond to the counterclaims.

Thus, the basis for the state court's decision to enter judgment as to liability in this case was merely the debtor's failure to comply with a technical rule of procedure. See generally Societe Internationale v. Rogers, 357 U.S. 197 (1958) (technical noncompliance, even with a court order, is not necessarily sufficient for entry of judgment under Fed. R. Civ. P. 37). Stripped of its technical effect, the only interest that the default procedure is designed to protect is the

interest of the state court in judicial economy; the state court's order was simply in aid of its desire to have cases filed in its court disposed of expeditiously in order to minimize the effects of a congested docket.[2]

C. Limited Scope of State Court Adjudication

Furthermore, the fact that the "judgment" in question was for liability only provides additional weight in support of the bankruptcy court's decision to set aside claims based upon it. The unusual New York procedure permitting entry of judgment as to liability produces a unique situation for the bankruptcy court. Under the federal rules, as well as the procedure of most states, a court entering a default judgment would first hold a hearing to determine the appropriate amount of damages. See Fed. R. Civ. P. 55. However

because of the automatic stay imposed by virtue of the filing of the bankruptcy petition, the bankruptcy court had to decide what effect, if any, to give this judgment entered without an assessment of damages.

The majority, in its effort to give full faith and credit to this state court determination, confronts a conceptual conundrum. It criticizes the bankruptcy court for "improperly incorporat[ing] some of its findings regarding liability, a matter already resolved by the state court default judgment." The majority then orders the bankruptcy court to hold a rehearing on damages "giving res judicata effect to the liability judgment of the state court." In referring to liability as a "matter already resolved," the majority leaves unclear whether it seeks to give res judicata effect to the state court

determination as a matter of issue or claim preclusion. It is clear, nonetheless, that a determination of only liability on claims such as those at issue in this case should only be entitled to res judicata as a matter of issue preclusion, if at all. It is a well-established principle of res judicata, however, that issues "resolved" are to be given preclusive effect only when "actually litigated and determined by a valid and final judgment." Restatement (Second) of Judgments § 27.

Calling liability a "matter already resolved" does not mask the true character of the state court's action as the imposition of a penalty based purely on a finding of procedural default. In the present case, all that was "actually litigated" by the state court was that the debtor did not comply with a procedural rule without adequate justification and not

any issue relating to the merits of the dispute. As a result, under general principles of res judicata such a default judgment would not have issue preclusive effect in subsequent litigation. Restatement (Second) of Judgments § 27 comment e at 257.[3] The majority is bootstrapping by assuming that because judgment was entered, issues going to the merits of the claim must have been litigated and resolved.

D. Interests of Third Party Creditors

The bankruptcy court's decision to disallow is further supported by the state court's inability to take into consideration the effect its imposition of a procedural penalty on the debtor would have on third-party creditors. The action of the state court may represent a sufficient determination of the rights of the debtor in his dispute with this one

particular creditor. However, given the interests of the other creditors in an equitable distribution of the bankrupt's estate, this state court judgment should not have preclusive effect in the context of the bankruptcy proceeding. The bankrupt's other creditors should not be required to suffer from the penalty imposed on the debtor because of his failure to comply with a procedural rule.

Professor Moore reasons similarly, in discussing a variation on the facts of the Heiser case, in which the issue was whether fraud had been involved in the procurement of a default judgment by a creditor. The point is, there are different interests to be protected, as Professor Moore perceptively observed:

> Let us . . . assume that the issue of fraud [in the procurement of a default judgment] had not been litigated by either the bankrupt or the trustee. This issue would

> then be open to the trustee when the creditor filed his claim based on his judgment, since the issue had not been adjudged, unless we are to take the position that since the issue . . . was open to the bankrupt, and as he allowed the creditor to obtain a default judgment against him, this foreclosed him, and his subsequent trustee with him. But this would work an undue hardship upon the creditors. . . . [I]n the interest of creditors we believe the trustee has the additional power to have a judgment claim disallowed or subordinated, though the judgment be binding on the bankrupt, when its enforcement in bankruptcy would, as to the creditors, run counter to sound principles of bankruptcy distribution, subject to the proposition that an issue which has been [f]airly adjudged is not open to readjudication.

1B J. Moore, Moore's Federal Practice ¶ 0.419[3.-6], at 684-85 (emphasis supplied).[4]

III. Bankruptcy Judge's Analysis of Merits of Creditor's Claims Also Supports Disallowance

The rationale concerning the character of the state court's determination is deepened by the bankruptcy judge's analysis

of the actual merits of the allegations asserted by the appellant in his state court counterclaims. The bankruptcy judge found that the creditor's allegations were "facially outrageous" and "wholly without merit," and concluded that the creditor's contentions were "groundless and were blown beyond reason, apparently to harass the debtor." In reaching this determination, the bankruptcy judge made no clearly erroneous factual findings. Nor do I find that the bankruptcy judge committed legal error in determining that res judicata did not bar the application of the paramount power of the bankruptcy court to review and disallow claims, or otherwise committed errors of law. See In re Hammons, 614 F.2d 399 (5th Cir. 1980) (on review, bankruptcy judge's factual findings must be accepted unless clearly erroneous; legal determin-

ations must be rejected if they are in error).

It should be noted that reasoned dicta in Heiser v. Woodruff supports disallowing a judgment claim upon a determination that the judgment in question was based upon "perjured allegations." See generally Heiser v. Woodruff, 327 U.S. 726 (1946). The bankruptcy judge came extremely close to making this kind of characterization concerning the appellant-creditor's claims. See In re Novak, 37 B.R. 31 (Bankr. D. Conn. 1983) (bankruptcy court granted debtor's motion to compel discovery on issue of whether creditor committed a "fraud" on the state court by making false statements in its complaint and affidavits). See also Kapp v. Naturelle, Inc., 611 F.2d 703 (8th Cir. 1979).

IV. Recapitulation

To sum up, the broad equity power of the bankruptcy court to achieve a just distribution of the bankrupt's estate militates against a mechanical application of res judicata to prior state court judgments. In this case, the bankruptcy court properly exercised that equity power in disallowing the judgment claims. A variety of circumstances combine to support the bankruptcy court's decision. The state court judgment was a default judgment that operated as a penalty upon the debtor for his failure to comply with a procedural rule. The state court did not adjudicate any of the merits. Consequently, contrary to the majority's assumption, no issues have been "resolved" for purposes of giving the state court's actions issue preclusive effect in the bankruptcy proceeding. In addition, giving res judicata effect to the

state court determinations might prejudice other creditors of the bankrupt's estate by requiring them to share in the procedural penalty assessed against the debtor. Finally, the contentions upon which the creditor based its claims were found by the bankruptcy judge to be wholly without merit.

I would affirm the court below.

FOOTNOTES

1/ By "fraud or collusion," the majority appears to refer only to acts such as those at issue in Margolis v. Nazareth Fair Grounds & Farmers Mkt., 249 F.2d 221 (2d Cir. 1957), where the judgment was procured through collusion between the parties to the prior action, with the primary purpose of diminishing the access of other creditors, and the bankruptcy estate, to certain assets. Even if I were to adopt the majority's view that only lack of jurisdiction and "fraud or collusion" represent grounds for failing to give res judicata effect to a state court judgment, there is in fact strong case authority for a broader view of the kind of behavior that constitutes "fraud" that might bring within its embrace the facts of this case. See infra at 12-13.

2/ Cf. Israel Aircraft Indus., Ltd. v. Standard Precision, 559 F.2d 203, 207 (2d Cir. 1977) (dismissal under Fed. R. Civ. P. 37 reserved only for extreme circumstances and is improper absent a court order to comply with discovery requests).

3/ I do not regard the bankruptcy court as rigidly bound by 28 U.S.C. § 1738 to give the same effect to this judgment, as matter of issue preclusion, as a New York court would give it. Even if I were to view the court as rigidly bound, however, I

would not be persuaded that a New York court would find that this default judgment determined any issues relating to the merits sufficiently to warrant the application of issue preclusion. Under New York law, it does appear that a default judgment is granted issue preclusive effect somewhat more readily than under the federal standard or that of most states' courts. However, I do not think a New York court would find that this "judgment" could serve as a basis for issue preclusion. "The general rule is well settled that the estoppel of a former judgment extends to every material matter within the issues which was expressly litigated and determined, and also to those matters which, although not expressly determined, are comprehended and involved in the thing expressly stated and decided, whether they were or were not actually litigated or considered." Pray v. Hegeman, 98 N.Y. 351 (1885). "[T]he estoppel is limited to the point 'actually' determined and 'necessarily decided.'" Heine v. Albin Gustafson Co., 461 N.Y.S.2d 934, 936 (N.Y. Sup. Ct. 1983) (citations omitted). As these tests have been applied by the New York courts, it does not appear that any issues relating to liability were actually resolved by the state court. See generally Heine, 461 N.Y.S.2d at 936-37.

4/ Moore's analysis applies to this situation. The trustee's lack of participation does not prevent the bankruptcy judge from seeking to

protect other creditors' interests, either on the bankrupt's motion or the judge's own motion. See American Anthracite & Bituminous Coal Corp. v. Arrivabene, 280 F.2d 119 (2d Cir. 1960).

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NEW YORK

C. RUSSELL KELLERAN, JR.,
EIGHTEEN MILE CORPORATION,

Plaintiffs,

-vs- CIV-85-799C

SLAVKO ANDRIJEVIC, a/k/a
AL ANDRIE,

Defendant.

This case involves an appeal from a final order of the United States Bankruptcy Court. The pertinent procedural history can be summarized as follows. Andrijevic [debtor] filed a petition in Bankruptcy Court seeking Chapter 13 relief on February 8, 1984. On June 18, 1984, debtor filed a motion to disallow three of Kelleran and Eighteen Mile Corporation's [creditors'] related claims for 1) unpaid legal fees and disbursements, 2) breach of contract, and 3) willful exaggeration of a mechanic's lien.[1] After a trial, the bankruptcy court

granted debtor's motion on May 24, 1985. Creditor subsequently appealed to this court.

The questions at issue now are 1) whether the bankruptcy court erred in disregarding the res judicata effect of a state court judgment fixing liability against the debtor for breach of contract and exaggeration of a mechanic's lien, and 2) whether the bankruptcy court erred in making clearly erroneous findings of fact and erroneous legal conclusions by disallowing creditors' claims. Before these issues can be discussed, however, a brief summary of the factual history of this rather complicated case is necessary.

In 1976, debtor and Kelleran formed Eighteen Mile Corporation with the purpose of purchasing plots of land, subdividing them, and then selling these sublots for profit. They initially invested and loaned

equal sums of money to Eighteen Mile Corporation, which purchased property from a partnership [the partnership], in which debtor was a member, for the sum of $225,900.00. This purchase price consisted of a payment of $50,000.00 cash and a mortgage interest in the balance. It is in the context of this business relationship that the three claims, now in issue, arose.

During the period 1976-80, Eighteen Mile Corporation sold sublots from the above-said property to various persons and entities. The corporation used a portion of these sales' proceeds to pay off the mortgage due the partnership. The remainder of the proceeds were used to reduce debtor and Kelleran's loans to Eighteen Mile Corporation.

In addition, as was noted by the bankruptcy court below, subsequent to the formation of Eighteen Mile Corporation,

Kelleran represented debtor on various legal matters, for which he was paid his usual hourly rate. In June of 1980, the record indicates that debtor approached Kelleran about representing him with regard to a $5,200.00 default judgment which had been taken against him by Herschel Reingold, Esq. [the Reingold judgment]. Kelleran testified that there was no special agreement regarding his fee in this matter, while debtor stated that Kelleran told him that there would be no charge. Despite Kelleran's efforts, debtor's motion to reopen the Reingold judgment was ultimately denied.

At about this same time, the business relationship between debtor and Kelleran began to deteriorate, and the decision was made to liquidate Eighteen Mile Corporation. According to Kelleran, he and debtor agreed, during the spring of 1980, to

complete construction of a house on the so-called "Lot 23" owned by the corporation and to share in the profit, if any. Later, in September of 1980, the record shows that Eighteen Mile Corporation sold five acres of raw land for $36,000.00, for which Kelleran received $20,000.00 in cash and debtor received $16,000.00 in promissory notes.

The debtor testified before the bankruptcy court that he consented to this disproportionate split only because he believed that it would satisfy the Reingold judgment (which had been purchased by the corporation) as well as reimburse Kelleran for his efforts in connection with the Reingold judgment.[2]

Creditors argue that this was not the case. They contend that debtor agreed to surrender his ownership interest in Eighteen Mile Corporation prior to the

above transaction and that he actually was entitled to none of the proceeds of the sale. Creditors say, in fact, that the $16,000.00 worth of promissory notes represented a $15,999.00 payment on the $17,000.00 balance from the loan initially made by the debtor to the corporation, and $1.00 was for the purchase by Eighteen Mile Corporation of Debtor's stock therein. See creditor's Exhibit D (attached to Item 4).[3] Creditors also say that the $20,000.00 they received from the sale went back into the corporation to be used to complete the construction of a house on "Lot 23" mentioned above. Kelleran contends that he was to obtain financing on behalf of Eighteen Mile Corporation for this project while debtor was, for his part, to supervise the construction work at the site.

Debtor disagrees. He contends that he agreed to supervise the house construction on Lot 23 only because he was to be paid a salary of $380.00 per week.[4] He says that he worked pursuant to this Agreement from April to December of 1980, but stopped because he was not getting paid and could no longer afford to work.

After creditor sent him a bill for $2,819.60 in connection with the Reingold judgment, debtor filed a mechanic's lien for $9,462.18 on the Lot 23 home for his claimed unpaid wages and subsequently tried to foreclose on this lien in state court. After Eighteen Mile Corporation served an answer and counterclaim, debtor defaulted on the counterclaim by not serving a reply. Subsequently, debtor tried to reopen the default judgment--which included, inter alia, a finding that debtor was liable for the willful exaggeration of a lien and

breach of contract -- but was unsuccessful. The state court judgment was granted on January 5, 1984, and the damage inquest was scheduled for February 23, 1984. In the interim, the debtor filed his bankruptcy petition, which automatically stayed the scheduled damage inquest and ultimately resulted in the instant appeal to this court.

Based on all of the above facts, the bankruptcy court below found that the state court default judgment was not entitled to res judicata effect. Margolis v. Nazareth Fair Grounds & Farmer's Market, 249 F.2d 221 (2d Cir. 1957); Heiser v. Woodruff, 327 U.S. 726 (1946); Pepper v. Litton, 308 U.S. 295 (1939); In re Farrell, 27 B.R. 241 (Bankr. E.D.N.Y. 1982).

Further, the bankruptcy court found that, contrary to creditors' position, debtor did not surrender its ownership

interest in Eighteen Mile Corporation with the sale of five acres of land in September of 1980. Instead, the court found that, following this sale, the parties conducted themselves in a manner that would suggest they remained co-owners after that time. Accordingly, because it found that Kelleran received sufficient net benefit to reimburse him for his legal services and to reimburse Eighteen Mile Corporation for the amount of the Reingold judgment, Kelleran's claim for attorney's fees was disallowed.

In addition, the bankruptcy court found that debtor did not breach his contract to Kelleran or Eighteen Mile Corporation in connection with the house construction on Lot 23. Instead, it found that debtor did not agree to supervise this work without pay during that time because he simply could not afford to do so. Moreover, the court found that creditors'

claims for 1) $56,935.65 in damages for contract breach and 2) $17,364.58 in damages for willful exaggeration of his mechanic's lien were wholly without basis in fact.

Based on this court's careful review of the facts and law of this case, I find as follows. First, I note that the Supreme Court has said that bankruptcy courts, as courts of equity, may set aside judgments where they are determined to be fraudulent or otherwise inequitable. Heiser v. Woodruff, supra at 723-33. See also Pepper v. Litton, supra. The leading case in the Second Circuit on this question is, as the bankruptcy court acknowledged, Margolis v. Nazareth Fair Grounds & Farmer's Market, supra.

In the Margolis case, the court said that bankruptcy courts are essentially courts of equity endowed with broad equity

powers, and "that fraud will not prevail, that substance will not give way to form, that technical consideration will not prevent substantial justice from being done." Margolis v. Nazareth Fair Grounds & Farmers Market, 249 F.2d at 223 (citing Pepper v. Litton, supra at 305). The court said, however, that the "equitable considerations underlying [the doctrine of res judicata] require its application in the absence of compelling circumstances to the contrary." It found that "[t]o the extent that equitable principles require re-examination by the bankruptcy court of the bases for the judgment where these bases have been previously adjudicated the doctrine of res judicata is inapplicable in bankruptcy proceedings" and the court could exercise "its equitable powers in going behind the judgment." Id. at 224. The court said that this was especially the

case where possible fraud in involved. Id. at 224-25.

All subsequent Second Circuit cases have followed the Margolis decision. See, e.g., Matter of Farrell, supra; In re Mastercraft Record Plating, Inc., 32 B.R. 106 (Bankr. S.D.N.Y. 1983); In re Nowak, 37 B.R. 31 (Bankr. D. Conn. 1983); In re Mastercraft Record Plating, Inc., 39 B.R. 654 (S.D.N.Y. 1984); cf. In re Alston, 49 B.R. 929, 933-35 (Bankr. E.D.N.Y. 1985).

Here, because the state court judgment involved in this case was a default judgment and involved claims which the bankruptcy court found incredible given its finding of the facts of this case, I find that the bankruptcy court did not commit error in failing to give the state court judgment res judicata effect. As Margolis and its progeny indicate, a bankruptcy court may refuse to do so if it finds, as

it did here, that equitable considerations warrant a contrary outcome.

I also find that the bankruptcy court's findings of fact in this case were not clearly erroneous, and its legal conclusions based on those factual findings were, in themselves, not erroneous. Notwithstanding the above, I found this case troubling in many respects. Despite the parties' representations during oral argument on January 17, 1986, I believe that there are many unresolved questions in this case which have made my appellate review very difficult. I find, for example, that the parties failed to develop the record regarding 1) the business arrangement between Kelleran and debtor with respect to legal work done by Kelleran in connection with the Reingold judgment; 2) the understanding of Kelleran and debtor about the construction and sale of the

house on Lot 23; 3) the legal effect, if any, of the sale of the five acres of land for $36,000.00, and the subsequent unequal sharing of profits between Kelleran and debtor; and 4) the reasoning behind the state court default judgment against debtor as well as its subsequent refusal to grant debtor's motion to reopen.[5]

Given the above, it is clear to this court that the bankruptcy court's decision below was based on the evidence and its evaluation of the credibility of the witnesses before it. It is clearly within that court's province to make such determinations. See, e.g., Matter of Hammons, 614 F.2d 399, 402 (5th Cir. 1980). In fact, I find that the bankruptcy court's findings of fact were reasonable ones given the record in this case. Because I also find that the court's legal conclusions based on these findings were also accurate,

the decision of the bankruptcy court below must be affirmed in all respects. Finally, this case is remanded back to the bankruptcy court for determination of any remaining unresolved issues.

So ordered.

JOHN T. CURTIN
United States District Judge

Dated: October 27, 1986

FOOTNOTES

1 Plaintiff Kelleran's original claim for attorney fees against debtor was for $2,819.60. The bankruptcy court found that this amount had been erroneously calculated and recalculated it in the amount of $2,772.10. Plaintiff Eighteen Mile Corporation's claim for breach of contract was in the amount of $56,935.65. Its claim for willful exaggeration of a mechanic's lien was for $17,364.58.

2 This seems to contradict debtor's other arguments, supra, that Kelleran agreed to represent him on his motion to reopen the Reingold judgment without charge.

3 As the bankrupty court noted below, the stock repurchase was contingent upon a separate agreement between debtor and two other persons. There is no information in the record to indicate that this transaction was ever consummated. The bankruptcy court also found that debtor "never understood or intended" that his acceptance of $16,000.00 in promissory notes was equivalent to a termination of his interest in the corporation. Moreover, the evidence indicates that debtor never surrendered his stock in Eighteen Mile Corporation (Item 7, p. 17).

4 Debtor contends that he and Kelleran entered into an oral contract regarding this matter.

5 It is apparent from my review of the instant record that either (1) there was no further evidence available on these issues; or (2) the attorneys simply failed to attempt to enter this evidence into the record here.

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

IN RE

SLAVKO ANDRIJEVIC a/k/a Al Andrie — 84-10258 M

Debtor

Edwin R. Ilardo, Esq.
Hamburg, New York
Attorney for Debtor

E. Thomas Jones, Esq.
Buffalo, New York
Attorney for Claimants
C. Russell Kelleran, Jr., Esq.
and Eighteen Mile Corporation

McGuire, USBJ

The debtor, Slavko Andrijevic a/k/a Al Andrie, filed a petition seeking relief under Chapter 13, Title 11, U.S.C. ("the Bankruptcy Code") on February 8, 1984. On June 18, 1984, the debtor filed a motion to disallow the related claims of C. Russell Kelleran, Jr., Esq. and Eighteen Mile

Corporation.[1] The trial on the objection to these three claims was commenced on August 22, 1984, was continued on December 19, 1984 and was concluded on December 31, 1984.[2] Decision was reserved and legal memoranda were filed by counsel.

For the reasons articulated below, this Court sustains the objection of the debtor and grants the motion to disallow both claims of Eighteen Mile Corporation as well as the claim of C. Russell Kelleran, Jr., Esq.

I

Pursuant to § 157(b)(2)(B), Title 28 U.S.C. [as amended in July, 1984] and § 506, Title 11 U.S.C., this Court has jurisdiction to rule on this motion.

II

The debtor (hereafter referred to as "Andrijevic") and the creditor, C. Russell Kelleran, Jr., Esq. (hereafter referred to as "Kelleran") began their business relationship in early 1976. At that time, they incorporated Eighteen Mile Corporation (hereafter referred to as "Eighteen Mile") with the purpose of buying, developing, and selling land. Each of the two shareholders invested $5,000 into the corporation, each loaned $21,500 to the corporation, and each consequently owned 50% of the corporation. Eighteen Mile then purchased land from a partnership, in which the debtor was a partner, for the sum of $225,900; $50,000 was paid in cash to the partners (the debtor, Leo Switala and Walter Kurowski), and the corporation gave the partnership a mortgage in the amount of $175,900. It is

in the context of this business relationship that the three claims, now in issue, arose.

A. THE KELLERAN CLAIM FOR ATTORNEY'S FEES

Subsequent to the formation of Eighteen Mile, Kelleran represented the debtor (in his individual capacity) on various - primarily real property - legal matters. The debtor paid Kelleran his usual hourly rate for legal services rendered. In June of 1980, the debtor approached attorney Kelleran about representing him with regard to a $5,200 default judgment which had been taken against him by Herschel Reingold, Esq. (the "Reingold judgment"). Kelleran agreed to undertake this representation and informed the debtor that he thought there were valid grounds for having the default reopened.

Kelleran testified that there was no special agreement regarding his fees in this matter; Andrijevic testified that Kelleran told him there would be no charge. Despite several appearances and briefs which Kelleran alleges he prepared for the debtor, the State Court, in the late fall of 1980, denied the debtor's motion to reopen the Reingold judgment.

In the meantime, the business relationship between Andrijevic and Kelleran began to deteriorate. In September of 1980, Eighteen Mile sold five acres of raw land for $36,000. Kelleran received $20,000 in cash and Andrijevic received $16,000 worth of promissory notes. Kelleran also received full title to a lot previously owned by the corporation, and valued at about $8,000, thus effecting a transfer from Andrijevic to Kelleran worth $4,000. Hence, Kelleran received net value

of $8,000 in excess of what Andrijevic received, despite the fact that they each owned 50% of the corporation.

Mr. Andrijevic testified that he consented to this disproportionate split in September, 1980, believing it would satisfy the Reingold judgment (which had previously been assigned from the debtor to the corporation) as well as reimburse Kelleran for his efforts in connection with the Reingold judgment.

In March, 1981, the debtor received a bill for legal services in the amount of $2,819.60. The debtor believes that he was billed the additional sum only because of the "falling out" between himself and his business partner/attorney.[3] The evidence supports this belief.

Kelleran testified that Andrijevic agreed to surrender his ownership interest in Eighteen Mile prior to this transaction

and that he was actually entitled to none of the proceeds of the sale of raw land; the $16,000 worth of promissory notes was a $15,999 payment on the $17,000 balance from the loan initially made by the debtor to Eighteen Mile,[4] and $1 was for the purchase by Eighteen Mile of Andrijevic's stock therein. (Tr. 12/19/84, p. 54.) Kelleran alleges that the $20,000 cash which was paid to him for this land went into the corporation. The creditor testified that this $20,000, plus the $10,000 he had personally borrowed, was to be used for completion of a house. (Tr. 12/19/84, p. 57.) Respondent's exhibit D in evidence purports to be the stock repurchase agreement referred to by Mr. Kelleran. However, according to its terms, the stock repurchase is contingent upon a separate agreement among Andrijevic, Pensenstadler and Lovendahl. The Court has no

information at all regarding whether this transaction was consummated. Moreover, the Court is persuaded that the debtor never understood or intended that his acceptance of $16,000 in promissory notes was tantamount to a termination of his interest in Eighteen Mile; he never surrendered the stock and was never requested to do so, although Mr. Kelleran claims to the contrary.

The Court is persuaded that both parties conducted themselves, after this sale occurred, in a manner consistent with Andrijevic still being a 50% owner of Eighteen Mile. Furthermore, creditor Kelleran clearly received from this sale a net benefit to himself sufficient to reimburse himself for his legal services and to reimburse Eighteen Mile for the amount of the judgment.[5] The claim for attorney's fees is disallowed.

B. EIGHTEEN MILE CORPORATION'S CLAIM FOR BREACH OF CONTRACT

One of the lots Eighteen Mile owned was 4639 Kingswood Lane (hereafter referred to as "4639"). The debtor, in his capacity as Kingswood Enterprises, did some initial excavating work on that lot in 1978 at a time when there was an interested potential purchaser. He excavated the basement and put in footers. However, the potential purchaser was unable to obtain a mortgage, and Kingswood Enterprises thereafter terminated its development of the lot.

The debtor testified that in the fall of 1979 he observed the son of attorney Kelleran leveling off 4639 with a bulldozer and that a month later he saw that construction of a house had begun there. The debtor had no foreknowledge of any purchase of the lot or any development agreement,

although at that time, he held an undisputed 50% ownership interest in the land, through Eighteen Mile.

In the spring of 1980 (i.e., prior to the "falling out"), Kelleran explained to the debtor that construction of the house at 4639 had been started by Russ Barcelona with an agreement that the land would be paid for out of the proceeds of the sale of the house. Since the purchasers had canceled their contract of sale, Barcelona had abandoned the house.

Kelleran requested the debtor to supervise the completion of the house; Eighteen Mile would then sell the completed house rather than trying to sell the lot with an unfinished house on it. The debtor testified and the Court finds that the arrangement was that the debtor would hire and supervise subcontractors in return for Eighteen Mile paying him on a weekly basis.

Kelleran's version of this arrangement is different: he alleges that he consulted with his partner (the debtor) as to the best way of dealing with the partially developed lot and that the debtor, contrary to debtor's testimony - credited by this Court, agreed to work until the house was completed, to provide services for no salary, and to be compensated ultimately out of sale proceeds paid to their corporation. The Court finds Mr. Kelleran's version of the facts unpersuasive. The debtor, at the time, was not able to afford to work without compensation.

There is no dispute as to the existence of an agreement that Andrijevic would oversee construction on site and that Kelleran would obtain and provide the financing. Kelleran did this: he borrowed $10,000 on June 10, 1980 from the Bank of

New York. (The question of the extent to which the debtor fulfilled his commitment to oversee construction is discussed below.) It is this Court's finding that Kelleran failed to abide by his obligation to pay the debtor for his construction services on a regular basis.[6]

Both parties testified that they believed it would cost about $60,000 to build this house and that they could sell it for about $70,000. (Eventually, the house sold for $52,000.) According to Mr. Kelleran's testimony, the figure of $60,000 took into account the following (already incurred) expenses: $8,000 for land, $21,000 for Boise Cascade pre-fab house, $1,800 for cellar walls, and $1,200 for outstanding labor costs incurred by Barcelona. Hence, the anticipated costs of completing the house, as of the date Kelleran solicited the debtor's assistance,

was approximately $28,000. The claim filed for the debtor's alleged breach of contract to complete the house is in the amount of $56,935.65.

The proof presented at trial as to the basis of this $56,935.65 figure is troubling, to say the least. According to the proof of claim filed by C. Russell Kelleran, the New York Supreme Court (Erie County) judgment entered January 5, 1984 provides the basis for this claim. However, that judgment is based upon a default[7] and only finds liability; the damage inquest had not yet been held as of the date of the debtor's bankruptcy petition and has been stayed since that date. See, § 362, Title 11 U.S.C. Consequently, the creditor attempted to explain and itemize the elements of damage which account for the $56,935.65 claim [claim #13], at the hearing. The proof

presented as to these elements was rather flimsy and often internally inconsistent. In light of the Court's finding that Mr. Andrijevic did not breach his agreement with Mr. Kelleran or Eighteen Mile, it is not necessary to examine the components of this claim. However, the Court believes that the elements alleged are so facially outrageous as to merit brief discussion.

(i) Element of Replacement Services

The compensatory portion of the damage claim, namely $9,187.50, is based upon the invoice submitted by creditor Kelleran for his services as the supervisor/general contractor who oversaw completion of the house, after the debtor's alleged breach. Respondent's Exhibit F purports to show that Kelleran spent 73.5 hours providing services that Andrijevic allegedly agreed

to do. Therefore, Mr. Kelleran is seeking compensation at the rate of $125 per hour (a higher rate than he is seeking as attorney).[8]

The Court has found a contract requiring the debtor to supervise completion of the house, but only (a) if debtor was paid a salary, and (b) if Mr. Kelleran financed completion. The evidence indicates suppliers were not paid, nor was Mr. Andrijevic. Therefore, Mr. Kelleran having breached his agreement, there is no ground upon which to allow this claim to damage.

Accordingly, to the extent the claim relates to the cost of replacement services, the claim must be disallowed.

(ii) Element of Interest Charges

A significant portion of this damage claim, namely, $29,512.23, is interest due

on loans taken to complete the house. (Tr. 12/19/85, p. 46; see resp. ex. H.)[9] The creditor here is seeking compensation from the debtor for interest which Eighteen Mile ultimately incurred for funds borrowed by Kelleran to build a house sold by that corporation. The Court sees no ground upon which the debtor has any liability for that interest. Not only did Mr. Kelleran breach the agreement with Mr. Andrijevic relative to paying Andrijevic and contractors hired by Andrijevic, but the delay claimed was more attributable to Mr. Kelleran's tardiness than Mr. Andrijevic's justifiably leaving the job.[10]

Accordingly, to the extent the creditor's claim relates to interest, the claim must be disallowed.

(iii) Element of Real Property Taxes, Utility Costs, Etc.

The creditor claims $6,050.08 in additional real estate taxes, utility costs and insurance resulted from delay alleged to be caused by Andrijevic's breach. (Tr. 12/19/84, p. 46.) This is based upon a period of delay commencing in the summer of 1980 (when the debtor allegedly breached) and continuing until August, 1983 (when the house was sold). Again, the Court finds no basis upon which Andrijevic can be held liable for these costs. In no event could delay be calculated to the date of sale, but only to the date of completion. Here, delay in completion is attributable solely to the actions of or inaction by Mr. Kelleran.

Accordingly, this portion of damages must be disallowed.

(iv) Element of Increased Materials

There is a claim of $6,152.24 for increased costs. Putting aside the fact that it was Mr. Kelleran who caused the delay, there was no persuasive evidence presented to support the creditor's calculation of this figure. The creditor merely took 3 1/2% of the total cost (i.e., $60,000) for each year and multiplied it by 3 to cover the three-year delay. (Tr. 12/31/84, pp. 14-15.) There is no rationale which could justify such an accounting procedure (there was even testimony that during the period of 1980-1983, costs of many construction materials actually declined in the Buffalo area).

This portion of the claim must be disallowed.

(v) Element of Consequential Damages

This claim, in the amount of $7,748.65, is classified by the creditor as consequential damages (Tr. 12/19/84, p. 45) but was never itemized or accounted for.

Accordingly, this portion of the claim must be disallowed.

(vi) Element of Additional Attorney's Fees

Creditor Kelleran alleges that additional attorney's fees were incurred in the closing of this sale because of the additional liens placed on this lot as a direct result of Andrijevic's claimed breach. The Court credits the debtor's testimony that it was Kelleran's responsibility to pay the subcontractors and that he failed to do so. Hence, responsibility for any liens resulting from

failure to pay laborers, lay with this creditor and not with the debtor.

The creditor is seeking attorney's fees in the amount of $5,734, based upon the invoice for the total of legal services rendered in the closing, minus the average fee in such a transaction (i.e., 1% of sale price). (Tr. 12/13/84, p. 24.) The closing was already complicated by the liens of Boise Cascade and of the unpaid laborers who worked for Barcelona. There, of course, is no basis for the creditor's allegation that any of these additional legal costs flow from any failure to perform on the part of Andrijevic.

Accordingly, this portion of the claim must also be disallowed.

Hence, the claim for breach of contract [claim #13] is disallowed in full.[11]

C. EIGHTEEN MILE'S CLAIM BASED ON COUNTERCLAIM TO DEBTOR'S MECHANIC'S LIEN

The basis for the creditor's final claim [#14 in the amount of $17,364.58] is based on its counterclaim of willful exaggeration, which it filed in response to the debtor's mechanic's lien.

As noted above, the Court is persuaded that the debtor had a valid claim for wages against this creditor and every right to a mechanic's lien. It further finds a judgment entered upon default of a plaintiff to respond to a counterclaim requires careful review. **See, Margolis v. Nazareth Fair Grounds & Farmer's Market,** 249 F.2d 221 (2d Cir. 1957); **see also, Heiser v. Woodruff,** 327 U.S. 726 (1946), **Pepper v. Litton,** 308 U.S. 295 (1939), and **In re Farrell,** 27 B.R. 241 (U.S.B.C., E.D.N.Y. 1982). For purposes of determining the allowability of claims, a

bankruptcy court may look behind a State Court judgment. In so doing, it is this Court's finding that the claim of willful exaggeration, surrounded by meritless claims and questionable professional conduct, is wholly without merit.

It should be pointed out that proofs of claim are filed under penalty of perjury. **See**, Official Bankruptcy Form No. 19.[12] This Court is disturbed that these three proofs of claim which are groundless and were blown beyond reason, apparently to harass the debtor, were filed by a member of the Bar.

The three claims are disallowed in full. It is finally noted that counsel for the debtor has not sought attorney's fees.

This order is entered without prejudice to such a future application.

So Ordered.

Dated: May 24, 1985

U.S.B.J.

FOOTNOTES

1 The claims being objected to are: (1) claim no. 3 of C. Russell Kelleran, Jr., Esq., in the amount of $2,819.60 [filed 4/20/84]; (2) claim no. 13 of Eighteen Mile Corporation, in the amount of $56,935.65 [filed 4/20/84]; and (3) claim no. 14 of Eighteen Mile Corporation, in the amount of $17,364.58 [filed 4/20/84].

2 The long delay between the first and second day of testimony was due to the inability of the creditor to appear because of medical problems.

3 For reasons which the debtor did not understand, Mr. Kelleran's office informed him, at this time, that it would no longer represent him because of a conflict of interest. When the debtor went to County Court later that day, he was informed that the time within which he could appeal the denial of his motion to vacate the Reingold judgment expired in a half hour.

4 There was no interest paid or mentioned.

5 The judgment was in the amount of $5,200 and the attorney's fees billed were in the amount of $2,800; the net benefit to Kelleran was $8,000. It should be noted that the precise amount of the bill, $2,819.60, is erroneously calculated and should be for $2,772.10 according to Kelleran's own testimony.

6 The parties both acknowledge that Kelleran conveyed only two checks, drawn on the Eighteen Mile account, to the debtor, for $200 each, during the entire term of construction.

7 The debtor filed the initial mechanic's lien action because of Eighteen Mile's failure to compensate him for his services. The defendant therein counterclaimed, and Andrijevic failed to file a reply. Judgment was entered against the debtor upon his default. It is unclear to the Court whether or not Mr. Andrijevic was represented by counsel at this time.

8 Note that if Mr. Kelleran's account had been credited, there is still no indication in the record as to the compensation the debtor would have been entitled to upon completion of the house. Kelleran's description of the agreement suggests to the Court that he (Kelleran) would obtain and provide financing, at the corporation's expense, and that Andrijevic would provide his supervisory services, at his own expense, and that upon sale, they would split the proceeds 50-50.

9 On December 31, 1984, Kelleran modified his testimony on the question of the amount of interest due to claim $24,638.78 (as of 12/31/84) and introduced resp. ex. L in support thereof.

10 It should be noted, moreover, that the manner in which this element of damages was calculated is somewhat

suspect. Exhibits H and L, as well as Kelleran's testimony, reflect a desire to recoup interest on a principal amount of approximately $29,000. In addition to the fact that this "loan" could never legally generate interest which would equal 100% of the principal over three years, it is also quite apparent that the interest element of damages ought to take into account the "mitigation efforts" put forth by the creditor. Mr. Kelleran testified that he repaid the loan, to the extent the funds were still in the Eighteen Mile account, as soon as he realized the debtor was not going to complete the house. (On Tr. 12/31/84, p. 11), Kelleran states that in September, 1980, he repaid the "net sum" of $10,450 to the Bank of New York so that there would be only a minimal amount on loan. He gave no indication of what portion of this was interest, but the record reflects an initial loan from Bank of New York for $10,000.)

11 The sum of all six elements actually exceeds the $59,935.65 amount set forth in the claim.

12 The penalty for presenting a fraudulent proof of claim is a fine of not more than $5,000 or imprisonment for not more than five years or both. § 152, 18 U.S.C.

At a Special Term of the Supreme Court held in and for the County of Erie at the Erie County Courthouse Building, Buffalo, New York, on the 2nd day of December, 1983

PRESENT: Hon. Federick M. Marshall, J.S.C.
Justice Presiding

STATE OF NEW YORK
SUPREME COURT : COUNTY OF ERIE

SLAVKO ANDRIJEVIC

Plaintiff

-vs-

ORDER FOR DEFAULT JUDGMENT

EIGHTEEN MILE CORPORATION,
VLADO CAROVSKI,
LEO SWITALA,
WAYNE PENSENSTADLER,
BOISE CASCADE CORPORATION,
SCHREIBER & WINKELMAN, INC.

Index No. H-11019

Defendants

Defendant, EIGHTEEN MILE CORPORATION, by its attorney, C. Russell Kelleran, Jr., having moved for an Order pursuant to CPLR 3215(a) directing the entry of Judgment in its favor and against the plaintiff for the

relief demanded in its Answer and Counterclaims, upon the ground the plaintiff was in default in replying to the allegations in said Counterclaim; and plaintiff having crossed moved to dismiss the said defendant's Answer and Counterclaim pursuant to CPLR 3215 and said motions having regularly come on to be heard,

Now, upon reading and filing the said defendant's Notice of Motion dated November 14, 1983, the Affidavit of C. Russell Kelleran, Jr., in support of said Motion, sworn to on the 14th day of November, 1983 and the Reply Affidavit of C. Russell Kelleran, Jr. in opposition to plaintiff's Cross Motion and Answering Affidavit, sworn to on the 1st day of December, 1983 and the Notice of Cross Motion by the plaintiff dated November 25, 1983, the Affidavit of Patrick C. O'Reilly in support of said Cross Motion and in opposition to said

defendant's Motion, sworn to on the 25th day of November, 1983, and after hearing E. Thomas Jones of Counsel to C. Russell Kelleran, Jr. for the defendant in support of its Motion and in opposition to plaintiff's Cross Motion, and Patrick C. O'Reilly of Counsel for the plaintiff in support of plaintiff's Cross Motion and in opposition to defendant's Motion, and after due deliberation having been held thereon, and on filing of the opinion of the Court dated December 14, 1983,

Now, upon Motion of E. Thomas Jones, of Counsel to C. Russell Kelleran, Jr., attorney for defendant, EIGHTEEN MILE CORPORATION, it is

ORDERED, that the plaintiff's Motion be and the same is hereby denied, and it is further

ORDERED, that the defendant's, EIGHTEEN MILE CORPORATION's, Motion be and the

same is hereby granted, and that judgment be entered in favor of the said defendant and against the plaintiff for the damages incurred by reason of the causes of action alleged in the Answer and Counterclaims, and it is further

ORDERED, that said damages be assessed by inquest.

FEDERICK M. MARSHALL
Justice of the Supreme Court

GRANTED:

Jan. 5-1984

Court Clerk _____

STATE OF NEW YORK
SUPREME COURT : COUNTY OF ERIE

SLAVKO ANDRIJEVIC

Plaintiff

-vs-

INDEX NO.
H-11019

EIGHTEEN MILE CORPORATION,
VLADO CAROVSKI,
LEO SWITALA,
WAYNE PENSENSTADLER,
BOISE CASCADE CORPORATION,
SCHREIBER & WINKELMAN, INC.

Defendants

LIPSITZ, GREEN, FAHRINGER,
ROLL, SCHULLER & JAMES
(Patrick C. O'Reilly of counsel)
for Plaintiff

C. RUSSELL KELLERMAN, JR.
(E. Thomas Jones of counsel)
for Defendant - Eighteen Mile
Corporation

OPINION OF THE COURT

FEDERICK M. MARSHALL, J.

The defendant, Eighteen Mile Corporation, has moved for entry of judgment against the plaintiff for the relief

demanded in the former's answer dated June 7, 1983.

The plaintiff has cross-moved to dismiss the defendant's answer and counterclaim pursuant to CPLR 3215.

The plaintiff's motion is denied.

The defendant's motion is granted and an inquest is directed to assess damages. (See CPLR 3215(f)(2)

Submit Order.

Dated: Buffalo, New York
December 14, 1983

FEDERICK M. MARSHALL
Justice Supreme Court

STATE OF NEW YORK
SUPREME COURT : COUNTY OF ERIE

SLAVKO ANDRIJEVIC

Plaintiff

-vs-

INDEX NO.
H-15928

EIGHTEEN MILE CORPORATION,
VLADO CAROVSKI,
LEO SWITALA,
WAYNE PENSENSTADLER,
BOISE CASCADE CORPORATION,
SCHREIBER & WINKELMAN, INC.

Defendants

LIPSITZ, GREEN, FAHRINGER, ROLL,
SCHULLER & JAMES
(Patrick C. O'Reilly of counsel)
for Plaintiff

C. RUSSELL KELLERMAN, JR.
for Defendant - Eighteen Mile
Corporation

ALBRECHT, MAGUIRE, HEFFERN
& GREGG, P.C.
(Joseph G. Makowski of counsel)
for Defendants - Vlado Carovski,
Leo Switala and Wayne Pensenstadler

PHILLIPS, LYTLE, HITCHCOCK,
BLAINE & HUBER
(Joseph Ritzert of counsel)
for Defendant - Boise Cascade
Corporation

OPINION OF THE COURT

FEDERICK M. MARSHALL, J.

Three motions arise out of this action commenced April 14, 1982 to foreclose a mechanic's lien on property owned in Hamburg, New York by the defendant Eighteen Mile Corporation (18 Mile).

Chronologically, the first motion for summary judgment was made by Boise Cascade which supplied materials to the original contractor, Custom Homes, and is itself the holder of a still outstanding lien filed on February 25, 1980 in the Erie County Clerk's office. Boise claims that the plaintiff and 18 Mile assumed the unpaid obligations of Custom Homes. Concededly, the plaintiff filed no notice of pendency of this action and allowed more than a year to lapse since the inception of this lawsuit.

Eighteen Mile brings the second motion for summary judgment on its counterclaims utilizing basically the same argument as its codefendant, viz. that the plaintiff has not timely served his reply nor moved for an extension and that he is in default.

The third motion is a combination of cross motions by the plaintiff seeking to be relieved of his default. In extended affidavits he denies that his lien is exaggerated. Despite the fact that he owned one-half of the stock in 18 Mile at the time the company decided to complete the home, a fact he fails to disclose in his initial affidavit dated June 17, 1983, or in a subsequent affidavit dated June 23, 1983, he contends that there was a separate agreement, apparently oral, for the corporation to pay him a weekly salary to finish construction. Although he never collected this weekly paycheck, he

continued his endeavors for some twenty-three (23) weeks.

In his third affidavit, dated July 5, 1983, the plaintiff who had sought to be excused from his default primarily because of his dire financial straits, finally lists a series of assets but contends, in conclusory fashion, that all are heavily encumbered.

On July 13, 1983, a week after argument in Special Term, the court was furnished with documents that show that the plaintiff, along with Vlado Carovski, and Leo E. Switala, codefendants in this action, were the holders of a 1976 mortgage in the sum of $175,900.00 on land owned by 18 Mile and which presumably covers the premises involved in this lawsuit.

As recently as July 2, 1980, the plaintiff participated in modification of this mortgage agreement. The third

individual defendant, Wayne Pensenstadler had become one of the holders of the mortgage. Plaintiff's affidavit, dated July 5, 1983 alleges a sale of property to Wayne Pensenstadler, but gives no details of the disbursements of the monies received.

The plaintiff claims that temporary employment in Pennsylvania, the exact site and tenure of which are not disclosed, prevented his attorney's mail from reaching him. There is no showing other than that his permanent residence was in Blasdell, to which he apparently had ready and constant access. He alludes to his alleged state of depression and confusion but submits no medical corroboration.

The courts constantly allude to the rule that "one asking for excuse for great delay in prosecution comes with a heavy burden of explanation. (citations

omitted)" (Frangione v Cordasco, 47 AD2d 996, 997; Bamford v Kaunitz, 37 AD2d 682, app dsmd 29 NY2d 672; Solomon v Perkins, 52 AD2d 753).

Under all the circumstances, I find the plaintiff's affidavits inconclusive and unsatisfactory.

The motion by defendants, Boise Cascade Corporation and Eighteen Mile Corporation, to dismiss the complaint, is granted. All other motions are denied.

Submit Order.

Dated: Buffalo, New York
August 8, 1983

FEDERICK M. MARSHALL
Justice Supreme Court